

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 ROME 7659

LIMDIS

FOR SECRETARY BLUMENTHAL FROM AMBASSADOR GARDNER

E. O. 11652: GDS
TAGS: EFIN, IT
SUBJ: MEETING WITH TREASURY MINISTER PANDOLFI

1. INTRODUCTION. THIS MORNING I MET WITH NEW TREASMIN PANDOLFI FOR TWO HOURS AND RECEIVED A CLEAR, CONCISE AND COMPREHENSIVE BRIEFING ON ITALY'S ECONOMIC SITUATION AND PROBLEMS. I BELIEVE YOU WILL FIND THE FOLLOWING REPORT ON THIS MEETING MOST USEFUL AS BACKGROUND FOR YOUR LUNCHEON IN MEXICO CITY WITH PANDOLFI NEXT WEEK.

2. SUMMARY. PANDOLFI EXPLAINED IN CONSIDERABLE DETAIL THE REASONS FOR THE LARGE PUBLIC SECTOR DEFICIT, EXPLAINING THAT HE INTENDS TO BE CANDID WITH PARLIAMENT AND THE PUBLIC AND AGGRESSIVE IN INTRODUCING MEASURES TO REDUCE THAT DEFICIT. HE GAVE ME A PREVIEW OF SOME OF THESE MEASURES. THE MINISTER WAS ALSO HOPEFUL THAT LABOR COSTS IN THE NEXT YEAR AND A HALF CAN BE CONTAINED, GIVEN THE RECENTLY-EXPRESSED FLEXIBILITY BY UNION LEADERS. WITH RESPECT TO THE ECONOMIC OUTLOOK, PANDOLFI INDICATED THAT THE ECONOMY MAY FACE SOME RISKS TOWARDS THE END OF THE YEAR. ON ITALY'S RELATIONS WITH THE IMF, HE INDICATED THAT WHITTOME IS COMING TO ROME
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FOR INFORMAL DISCUSSIONS MAY 10-11. HIS VISIT WILL BE FOLLOWED TOWARDS THE END OF MAY BY AN IMF MISSION FOR THE REGULAR ARTICLE VIII CONSULTATIONS. AFTER THESE CONSULTATIONS, AND PERHAPS TOWARD THE LATTER PART OF JUNE OR EARLY PART OF JULY, HE EXPECTS TO START NEGOTIATIONS FOR A NEW STANDBY, HOPEFULLY FOR \$1 BILLION. PANDOLFI EXPRESSED RESERVATIONS ABOUT SOME OF THE MORE AMBITIOUS SCHEMES FOR EUROPEAN MONETARY UNION. END SUMMARY.

3. PANDOLFI SAID THAT HE WAS ADOPTING A POLICY OF COMPLETE CANDIDNESS WITH RESPECT TO THE BUDGET DEFICIT IN AN EFFORT TO AVOID THE ENDLESS DISCUSSIONS AND SPECULATIONS. HE NOTED THAT HE INFORMED PARLIAMENT LAST WEEK THAT THE PROJECTED CASH DEFICIT OF THE ENLARGED PUBLIC SECTOR FOR 1978 IS 29,280 BILLION LIRE. ADOPTING THE CONCEPT OF BORROWING REQUIREMENTS BY THE PUBLIC SECTOR, THAT FIGURE IS INCREASED BY 6,000 BILLION LIRE, BECAUSE 1,100 BILLION LIRE FOR TRANSFERS TO THE ENDOWMENT FUNDS OF STATE PARTICIPATION INDUSTRIES AND 4,900 BILLION LIRE FOR REPAYMENT OF ACCUMULATED DEBTS BY LOCAL AUTHORITIES ARE OFF-BUDGET EXPENDITURES. HE EXPLAINED THAT THE ENLARGED PUBLIC SECTOR IN ITALY INCLUDES THE NATIONAL TREASURY, LOCAL AUTHORITIES, PENSION SYSTEM, HEALTH AGENCIES, AND THE STATE-OWNED ELECTRIC COMPANY. WHILE THE PROJECTED DEFICIT FOR 1978 IS CONSIDERABLY ABOVE LAST YEAR'S LEVEL (OF ABOUT 21,000 BILLION LIRE), HE NOTED THAT SOME EXPENDITURES TAKE THE FORM OF FINANCIAL TRANSFER TO INDUSTRIES, SUCH AS THE FISCALIZATION OF SOCIAL BENEFITS, WHICH TEND TO IMPROVE THE LIQUID POSITION OF PRIVATE ENTERPRISE. HENCE, IN ANALYZING CREDIT ALLOCATION BETWEEN THE PUBLIC AND PRIVATE SECTOR, THIS MUST BE TAKEN INTO ACCOUNT. THE MINISTER INDICATED THAT IN MAY HE PLANS TO PRESENT TO PARLIAMENT A PLAN ("MINI'BUDGET") ON HOW HE EXPECTS TO REDUCE THE DEFICIT. WHILE THE GOVERNMENT'S TARGET IS STILL 24,000 BILLION LIRE, HE OPINED THAT IT WOULD BE DIFFICULT TO MEET THAT TARGET DURING CALENDAR YEAR 1978.

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4. PANDOLFI THEN GAVE ME A PREVIEW OF THE KIND OF MEASURES HE EXPECTS TO PRESENT TO PARLIAMENT. HE OUTLINED FOUR SPECIFIC AREAS FOR IMMEDIATE ACTION.

5. PENSIONS. PANDOLFI STRESSED THAT THE DEFICIT OF THE PENSION SYSTEM WAS THE MOST SERIOUS PROBLEM AND THE MOST DIFFICULT TO SOLVE BECAUSE IT WAS HARD TO UNDO IN ONE YEAR THE MISTAKES OF 20 YEARS. HOWEVER, HE INTENDS TO MOVE AHEAD WITH EFFORTS TO TIGHTEN THE CRITERIA FOR DISABILITY PENSIONS, INCREASE THE CONTRIBUTIONS OF SELF-EMPLOYED TO THE PENSION FUND, LIMIT THE NUMBER OF PENSIONS ANY ONE INDIVIDUAL CAN RECEIVE, AND PLACE A CAP ON THE INDEXATION OF PENSIONS.

6. AS INDICATIVE OF THE SEVERITY OF THE PROBLEM OF THE PROBLEM OF PENSION SYSTEM, PANDOLFI CITED THE FOLLOWING EXAMPLES. HE NOTED THAT IN A PARTICULAR PROVINCE IN SOUTHERN ITALY (AVELLINO) WITH A TOTAL POPULATION OF 420,000, THAT 95,000 INDIVIDUALS ARE RECEIVING DISABILITY PENSIONS. AS INDICATIVE OF THE DISPARITY BETWEEN CONTRIBUTIONS AND BENEFITS, HE POINTED OUT THAT SELF-EMPLOYED AGRICULTURAL WORKERS CONTRIBUTE ON AVERAGE 90,000 LIRE PER YEAR, WHILE THE AVERAGE BENEFITS RECEIVED AMOUNT TO 1,400,000 LIRE. PANDOLFI AGREED WITH ME THAT HIS EFFORTS TO REDUCE THE PENSION DEFICIT

WOULD HURT HIS OWN PARTY'S ELECTORAL CHANCES, SINCE MOST OF THE RECIPIENTS OF THESE PENS PANS VOTE FOR CHRISTIAN DEMOCRATS. HOWEVER, HE IS APPARENTLY DETERMINED TO TAKE IMMEDIATE STEPS, EVEN THOUGH HE EXPECTS THE FULL IMPACT TO BE FELT OVER A NUMBER OF YEARS. IN ANSWER TO A QUESTION ABOUT POLITICAL SUPPORT, HE SAID THAT HE HAD NO PROBLEM WITHIN THE CABINET. HE DID ACKNOWLEDGE DIFFICULTIES WITH LABOR UNIONS AND WITH THE AGRICULTURAL COOPERATIVES REPRESENTING THE SELF-EMPLOYED AGRICULTURAL WORKERS. HE RIGHTLY SAID IT'S HARD TO TAKE AWAY AN "ACQUIRED RIGHT."

7. HEALTH. THE SECOND AREA HE IS GOING TO TRY TO CUT BACK ON IS HEALTH SPENDING. HIS FIRST ACTION IS TO TRY TO BLOCK HEALTH REFORM LEGISLATION NOW BEFORE PARLIAMENT WHICH WOULD INCREASE THE ALREADY LARGE DEFICIT OF THIS SECTOR BY 5,000 TO 6,000 BILLION LIRE. HE
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PLANS TO FOLLOW TO THE LETTER THE LANGUAGE OF THE GOVERNMENT'S PROGRAM WHICH STATES THAT NO NEW EXPENDITURES ARE TO BE UNDERTAKEN UNLESS SPECIFICALLY PROVIDED FOR IN THE AGREEMENT. WHILE THIS IS ANOTHER POLITICALLY SENSITIVE PROBLEM, PANDOLFI INDICATED EVERY INTENTION OF MOVING AHEAD. HE FEELS THERE IS GENERAL CONSENSUS WITHIN THE PARTIES TO PROCEED, ALTHOUGH HE ACKNOWLEDGED A GAP BETWEEN WHAT PARTY LEADERS SAY AND WHAT THEY DO.

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8. LOCAL AUTHORITIES. THE THIRD AREA OF ACTION IS LOCAL AUTHORITIES' DEFICITS. WHILE STAMMATI MADE PROGRESS ON THIS FRONT, PANDOLFI THOUGHT THAT MUCH MORE NEEDED TO BE DONE. HE THEN EXPLAINED A VERY INTERESTING PHENOMENON. SINCE 1965 THERE HAS BEEN A KIND OF COMPETITION FOR TREASURY FINANCING BETWEEN DC-RUN COMMUNES AND COMMUNIST-RUN COMMUNES. THE COMMUNIST PARTY APPARENTLY URGED COMMUNIST AUTHORITIES AT THE LOCAL LEVEL TO RUN DEFICITS AS LONG AS THE TREASURY FINANCED THE DEFICITS OF THOSE COMMUNES TRADITIONALLY RUN BY THE CHRISTIAN DEMOCRATS. UNFORTUNATELY, DC-RUN COMMUNES HAVE INCREASED THEIR DEFICITS BY BLOATING THEIR PAYROLLS WITH PEOPLE WITH NOTHING TO DO. THE COMMUNIST-RUN COMMUNES, ON THE OTHER HAND, HAVE INCREASED THEIR DEFICITS BY PROVIDING FREE SERVICES TO ITS RESIDENTS. FOR EXAMPLE, HE CITED THE CITY OF BOLOGNA, WHICH IS RUN BY THE COMMUNISTS, WHERE 47 PERCENT OF ITS EMPLOYEES RUN PRE-SCHOOL ACTIVITIES (NURSERY SCHOOLS AND KINDERGARTENS). HE ALSO SAID REGIONS ARE NOT EFFECTIVELY ADMINISTERED AND ARE THUS UNABLE TO SPEND ALLOTTED FUNDS FOR INVESTMENT PROJECTS. IN THIS RESPECT, HE PLANS TO CENTRALIZE THE FUNDING OF THE REGIONS SO THAT THERE CAN BE A BETTER CONTROL ON SUSPECT EXPENDITURES. WITH REGARD TO THE COMMUNES, PANDOLFI NOTED THAT A PARTIAL

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SOLUTION IS TO HAVE THEM CHARGE MORE REALISTIC RATES FOR THEIR SERVICES, SUCH AS TRANSPORTATION.

9. PUBLIC SERVICE TARIFFS. PUBLIC SERVICE RATES IS THEN THE FOURTH PROBLEM AREA. HOWEVER, THIS PROBLEM IS ON THE WAY TO SOLUTION, SINCE THE GOVERNMENT AND THE PARTIES HAVE ALREADY AGREED TO RAISE TARIFFS FOR ELECTRICITY, TRANSPORTATION, AND TELEPHONES.

10. LABOR COSTS. TURNING TO LABOR COST, PANDOLFI SAW A NUMBER OF POSITIVE SIGNS. THE UNIONS ARE PREPARED TO MODERATE THEIR WAGE DEMANDS IN THE NEXT ROUND OF NEGOTIATIONS. HE SAID THE GOVERNMENT HOPES TO MAKE THE RECENTLY-SIGNED CONTRACT WITH AIRPORT WORKERS A MODEL FOR OTHER AREAS. THIS CONTRACT GAVE A BASIC INCREASE OF 1.8 PERCENT PER YEAR OVER A THREE-YEAR PERIOD, BEFORE INCREMENTS PROVIDED BY INDEXATION. ANOTHER POSITIVE ELEMENT CITED BY PANDOLFI WAS THAT THE UNIONS ARE SHOWING A GREATER FLEXIBILITY IN ADOPTING MEASURES TO INCREASE PRODUCTIVITY. ALSO, JUDGES IN LABOR COURTS ARE MORE OFTEN UPHOLDING EMPLOYERS' DECISIONS TO FIRE WORKERS FOR JUST CAUSE. ON THE NEGATIVE SIDE, THERE REMAINS THE PROBLEM OF WAGE INDEXATION WHICH OVERCOMPENSATES FOR INFLATION AND CONTINUED UNION RIGIDITY ON LABOR MOBILITY.

11. ECONOMIC OUTLOOK. ON THE ECONOMIC SITUATION, PANDOLFI BELIEVES THAT THE ECONOMY WILL HAVE ANOTHER FEW MONTHS OF RELATIVE CALM. THE BALANCE OF PAYMENTS IS UNDER CONTROL AND INFLATION IS RUNNING ACCORDING TO PLANS, I.E., AROUND 13 PERCENT, ANNUAL RATE. HOW-

EVER, PANDOLFI IS CONCERNED THAT THE ECONOMY MAY RUN SOME RISKS TOWARD THE END OF THE YEAR. HE INDICATED THAT BUSINESS CYCLE MOVEMENTS IN ITALY ARE DOMINATED BY STOCK ADJUSTMENTS AND THAT THE CURRENT LEVEL OF STOCKS IS VERY LOW. SHOULD THE ECONOMIC SITUATION INDUCE INDUSTRY TO MAKE A SUBSTANTIAL INCREASE IN STOCKS, STRAINS COULD DEVELOP, BOTH FOR THE BALANCE OF PAYMENTS AND INFLATION. THE SITUATION IS COMPLICATED BY GOVERNMENT
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PLANS TO REPAY ACCUMULATED DEBTS OF LOCAL AUTHORITIES (ABOUT 4,900 BILLION LIRE) WHICH REPRESENT AN ADDITIONAL INJECTION OF LIQUIDITY INTO THE SYSTEM WITH POSSIBLE ADVERSE CONSEQUENCES ON THE CONTROL OF THE MONEY SUPPLY.

12. IMF RELATIONS. PANDOLFI TOLD US CONFIDENTIALLY THAT HE WILL BE HAVING INFORMAL DISCUSSIONS WITH WHITTOME IN ROME MAY 10-11. THIS IS TO BE FOLLOWED BY AN IMF MISSION TOWARDS THE END OF MAY FOR REGULAR ANNUAL ARTICLE VIII CONSULTATIONS. AFTER THE COMPLETION OF THESE CONSULTATIONS, PANDOLFI PLANS TO START NEGOTIATIONS FOR A NEW STANDBY WHICH HE HOPES TO SIGN BY AUGUST. HIS PLAN IS TO TRY TO NEGOTIATE A NEW LOAN FOR \$1 BILLION. HE IS ALSO HAVING TALKS WITH THE EC IN MID-MAY WITH THE OBJECTIVE OF TRYING TO CONTRACT ADDITIONAL FINANCING.

13. DEBT FINANCING. THE MINISTER WAS NOT AT ALL CONCERNED ABOUT ITALY'S ABILITY TO REPAY ITS \$4.9 BILLION IN DEBT THIS YEAR. HE NOTED THAT \$1.2 BILLION WAS ALREADY PAID. AS FOR THE BALANCE, THE CURRENT ACCOUNT IS PROJECTED TO BE IN SURPLUS BY ABOUT \$2 BILLION, AND DIDN'T SEE ANY PROBLEM IN OBTAINING SUFFICIENT FINANCING TO MEET REPAYMENT OBLIGATIONS.

14. EUROPEAN MONETARY UNITY. PANDOLFI INDICATED THAT THERE ARE TWO POSITIONS IN EUROPE ON THE ISSUE OF MONETARY UNION. THERE IS THE SCHMIDT POSITION AND THE EC COMMISSION'S POSITION. HE DESCRIBED THE SCHMIDT POSITION AS AMBITIOUS AND ONE WHICH ITALY COULD NOT SUPPORT AND THE EC POSITION AS REALISTIC AND ONE WHICH ITALY COULD SUPPORT. THE SCHMIDT PLAN WOULD HAVE THE WORLD DIVIDED INTO THREE MONETARY AREAS: THE DOLLAR AREA, THE EUROPEAN AREA, AND THE YEN AREA. THE PLAN IMPLIES THAT EUROPE WOULD GO BACK TO A KIND OF BRETTON WOODS SYSTEM OF FIXED BUT ADJUSTABLE RATES, WHICH PANDOLFI DID NOT BELIEVE WAS FEASIBLE, GIVEN THE DISPARITY OF INFLATION RATES WITHIN EUROPE. THE EC COMMISSION'S PROPOSAL, HE SAID, WOULD AIM AT CLBCER EXCHANGE RATE POLICY COORDINATION BUT WITH EXCHANGE RATES MAINTAINING CONSIDERABLE FLEXIBILITY.

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15. COMMENT. PANDOLFI'S BRIEFING WAS THE MOST LUCID, COMPREHENSIVE AND FORTHCOMING EXPOSITION OF ITALY'S ECONOMIC PROBLEMS I HAVE RECEIVED DURING MY STAY IN ITALY. MY MEETING WITH HIM TODAY HAS RE-CONFIRMED MY BELIEF THAT HE IS ONE OF THE BRIGHTEST AND MOST EFFECTIVE MEMBERS OF THIS GOVERNMENT. I ALSO BELIEVE THAT HE WILL MAKE AN EXCELLENT IMPRESSION ON INTERNATIONAL CREDITORS, SUCH AS THE IMF, AND THAT CONCERNS EXPRESSED BY SOME ABOUT STAMMATI'S REMOVAL FROM TREASURY ARE CERTAINLY UNWARRANTED.
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